TYPES OF MARKET RISK

➲ **Interest Rate Risk** is the risk that the relative value of a security, especially a bond, will worsen due to an interest rate increase. This risk is commonly measured by the bond's duration.

➲ **Credit risk** is the risk of loss due to a debtor's non-payment of a loan or other line of credit (either the principal or interest (coupon) or both)

➲ **Liquidity risk** arises from situations in which a party interested in trading an asset cannot do it because nobody in the market wants to trade that asset. Liquidity risk becomes particularly important to parties who are about to hold or currently hold an asset, since it affects their ability to trade.

➲ **Volatility risk** in financial markets is the likelihood of fluctuations in the exchange rate of currencies. Therefore, it is a probability measure of the threat that an exchange rate movement poses to an investor's portfolio in a foreign currency. The volatility of the exchange rate is measured as standard deviation over a dataset of exchange rate movements.

➲ **Operational risk**[1] is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

Examples of Operational Risk

- technology failure
- business premises becoming unavailable
- inadequate document retention or record-keeping
- poor management, lack of supervision, accountability and control
- errors in financial models and reports
- attempts to conceal losses or make personal gains (rogue trading)
- third party fraud

➲ **Market risk** is the risk that the value of an investment will decrease due to moves in market factors. The four standard market risk factors are:

- **Equity risk**, or the risk that stock prices will change.
- **Interest rate risk**, or the risk that interest rates will change.
- **Currency risk,** or the risk that foreign exchange rates will change.
- **Commodity risk**, or the risk that commodity prices (i.e. grains, metals, etc.) will change.

[1] Although the risks apply to any organization in business it is of particular relevance to the banking regime where regulators are responsible for establishing safeguards to protect against systemic failure of the banking system and the economy.

Consequences of Currency Volatility Risk

- Reduces volume of international trade
- Reduces long term capital flows
- Increases speculation
- Increases resources absorbed in risk management
- Economic policy making becomes difficult

INTERNATIONAL MARKET RISKS

Economic risks

- Risk of insolvency of the buyer,
- Risk of protracted default - the failure of the buyer to pay the amount due within six months after the due date
- Risk of non-acceptance
- Surrendering economic sovereignty

Political risks

- Risk of cancellation or non-renewal of export or import licences
- War risks
- Risk of expropriation or confiscation of the importer's company
- Risk of the imposition of an import ban after the shipment of the goods
- Transfer risk - imposition of exchange controls by the importer's country or foreign currency shortages
- Surrendering political sovereignty

ABOUT VOLATILITY

Volatility most frequently refers to the standard deviation of the change in value of a financial instrument with a specific time horizon.

- Used to quantify the risk of the instrument over that time period.

- Volatility is expressed in annualized terms

- Expressed as an absolute number (5$) or a fraction of the initial value (5%).

Volatility is often viewed as a negative in that it represents uncertainty and risk. However, volatility can be good in that if one shorts on the peaks, and buys on the lows one can make money, with greater money coming with greater volatility. The possibility for money to be made via volatile markets is how short term market players like day traders hope to make money, and is in contrast to the long term investment view of buy and hold.

Volatility does NOT imply direction.
Types of assets experience periods of **high and low volatility**. That is, during some period's **prices go up and down quickly**, while during other times, they can seem to move almost not at all for a long time.

FIVE TYPES OF BUSINESS RISKS

1. Strategic
2. Compliance
3. Financial
4. Operational
5. Other

❑ Strategic risks
are those risks associated with operating in a particular industry.

They include risks arising from:

- merger and acquisition activity
- changes among customers or in demand
- industry changes
- research and development

❑ Compliance Risk
Compliance risks are those associated with the need to comply with laws and regulations.

❑ Financial risks
Financial risks are associated with the financial structure of your business, the transactions your business makes, and the financial systems you already have in place.

- Identifying financial risk involves examining daily financial operations,
- Watching cashflow.

❑ Operational risks
Operational risks are associated with your business' operational and administrative procedures. These include:

- recruitment
- supply chain
- accounting controls
- IT systems
- internal rules, policies & procedures
- board composition

❑ Other Risks
- environmental risks, including natural disasters
- employee risk management, such as maintaining sufficient staff numbers and cover, employee safety and up-to-date skills
- political and economic instability in your foreign markets - if you export goods
- health and safety risks

RISK MANAGEMENT & AVOIDANCE

:: 4 Ways to Deal with Risk
There are **four ways of dealing with**, or managing, each risk that you have identified. You can:

- Accept it
- Transfer it
- Reduce it
- Eliminate it

Avoid Risk
(d) A portfolio is truly market neutral if it exhibits zero correlation with the unwanted source of risk.

:: Risk Management
- Insurance Policies
- Manipulating long-term, short term financial instruments
- Adding controls and monitors

:: Risk Management- Preventative Measures:
- methodically identifying the risks surrounding your business activities
- assessing the likelihood of an event occurring
- understanding how to respond to these events
- putting in place systems to deal with the consequences
- monitoring the effectiveness of your risk management approaches and controls

INSURANCE & RISK

Insurance will not reduce your business' risks but you can use it as a financial tool to protect against losses associated with some risks. This means that in the event of a loss you will have some financial recompense

:: Insurarable Risk: What is insurable?
Insurable risk is a risk that meets the ideal criteria for efficient insurance. The concept of insurable risk underlies nearly all insurance decisions.

For a risk to be insurable, several things need to be true:

- The insurer must be able to charge a premium high enough to cover not only claims expenses, but also to cover the insurer's expenses. In other words, the risk cannot be catastrophic, or so large that no insurer could hope to pay for the loss.

- The nature of the loss must be definite and financially measurable.

- The loss should be random in nature, else the insured may engage in adverse selection